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Market Strategy

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2011 Market Outlook

Looking back at 2010, we saw many things play out that were very close to our outlook forecast made a year ago, as well as observing some significant surprises. Heading into December, the major stock market indices are in positive territory and still have a very good chance of ending 2010 with high single digit percentage gains. Bond yields remained very low, in line with our forecast. The economy has grown at a slightly slower than expected pace in 2010 and unemployment has remained stubbornly high at 9.6 percent. Global geo-political events provided most of the negative surprises during the year with the European debt crisis, centering on Greece and Ireland, being the major market-moving events.

Tensions between North and South Korea and concerns regarding efforts by the People's Bank of China to stem inflation also triggered negative reactions globally in the currency, commodity, and equity markets. Mid-year, investors were concerned about a dip in the growth rate of the economy. Fortunately, the economy avoided a double-dip recession, strengthening slightly in the third quarter. Economic indicators suggest further strengthening in the fourth quarter.

We saw gold rise to set a new record high in 2010 at $1,410/ounce, well above our forecast. Short-term interest rates fell to record low levels in the United States. The dollar went on a wild roller-coaster ride versus the euro and yen. Finally, the November 2nd elections brought a change in the House of Representatives leadership in Washington and reshaped the composition of the U.S. Senate, with six Senate seats moving to Republican candidates. The change in Congressional membership leaves questions unresolved about many important policy issues including personal and corporate income tax reform, modifications to the 2010 Healthcare and Financial Reform bills, the level of the federal fiscal budget deficit, unemployment benefit extensions, and President Obama's energy policy.

Looking ahead to 2011, we believe the economy will continue to strengthen, resulting in real Gross Domestic Product (adjusted for inflation) growing at a 3 percent rate for the year, slightly above the 2010 growth rate. This growth rate will most likely come in below the average growth rate seen during the third year of an economic recovery. We project that housing will continue to be a major problem, with prices stabilizing nationally, although continuing to decline in the most depressed areas of the country as banks continue to unload the nearly two million foreclosed properties currently on their books or that will be coming onto their books in 2011. We project the unemployment rate will decline slightly next year to a 9 percent rate, reflecting an increase in small business hiring as restrictive bank lending practices slowly recede offset by more public sector layoffs. We project investment spending will continue to accelerate, advancing as much as 10 percent next year as corporate profits set another record, increasing approximately 11 percent in 2011. We project S&P 500 operating earnings to be $90 in 2011, up from an estimated $80 in 2010.

We project interest rates to remain very low in 2011. The Federal Reserve has signaled that it intends to keep interest rates low in order to stimulate the current sluggish economy. With inflation remaining low, we do not see the Fed increasing its short-term fed funds target interest rate until the unemployment rate dips significantly, perhaps to the 8 percent level in 2012 or beyond. In addition, the Fed appears intent on implementing its proposed $600 billion quantitative easing program through the purchase of U.S. Treasury securities during the remainder of 2010 and through mid-year 2011. This program should keep longer-term maturity U.S. Treasury interest rates low due its position of being the largest buyer of those instruments in the capital markets. If inflation begins to increase, we see rising price risk to holding bond portfolios containing long maturity bonds and highly leveraged fixed income mutual funds.

Looking at the currency and commodity markets, we project greater price volatility than seen this year for the major currencies and hard commodities including gold, silver, and crude oil. Given the spreading bank debt problems in Europe, we see the dollar moving in a fairly wide trading range versus the euro. We see the euro trading in a $1.15 to $1.45 range in 2011 with above average price volatility. We see commodity prices stabilizing in 2011, although moving in wide trading ranges. We forecast that gold will move up to $1500/ounce during 2011, but show more price volatility than seen during the second half of 2010. We project that crude oil futures price will track in a $70 to $95/barrel range, reflecting above average geo-political risks as well as increased demand for crude due to the expansion of the global economic recovery.

We are looking for 2011 to be kind to equity investors. We forecast the Dow Jones Industrial Average and the S&P 500 to end 2011 with 10 percent to 15 percent gains versus year-end 2010. Our forecast primarily reflects investors moving funds away from the bond and money markets and back into undervalued equities as 2011 progresses. In addition, we expect investors to more appropriately value a projected 2011 operating earnings growth rate of 11 percent for the S&P 500. The third year of the Presidential election cycle historically has delivered positive returns, especially when the Fed is stimulating the economy through aggressive monetary policy. We have not seen a major equity market cyclical peak occur since 1950 when the Fed held interest rates low and steady or when they lowered rates. Our equity market forecast also considers investors positively reacting to efforts by Congress to stem the massive federal budget deficits and take more time deliberating important Obama administration policy initiatives.

We continue to favor equity investments that have exposure to emerging growth economies. As well, we continue to favor stocks with solid balance sheets, rising analyst earnings estimates, and long histories of annual dividend payout increases. We believe that economically sensitive market sectors (Industrials, Materials, Energy, and Information Technology) will outperform the more defensive issues (Health Care, Consumer Staples, Utilities, and Telecom). We believe that Financial and Consumer Discretionary stocks will perform in line with the major market sectors next year.

Investors should consider the major risks to our 2011 economic and market outlook. These factors include the escalation of geo-political tensions in Korea and the Middle East, acceleration of the European debt crisis, an unexpected increase in the inflation rate or an unexpected slowing of the U.S. economy, larger than expected increases in personal and corporate tax rates, and unexpected changes in Federal Reserve monetary or quantitative easing policy during 2011.

Fred H. Dickson, CMT
Senior Vice President, Chief Investment Strategist
Davidson Companies
503.603.3059
fdickson@dadco.com